USA playing with financial fire

By Elisa Barwick

With currency instability doubling the US-dollar-debt burdens of some emerging market economies since the beginning of the year, many leading financial experts are warning the US government and the Federal Reserve to consider their future financial actions and the possible consequences very carefully.

Some, like former investment banker and author Nomi Prins, propose to end the rampant speculation by commercial banks which the US government has protected since the 1999 repeal of the *Glass-Steagall Act*, which had prohibited deposit-taking banks from speculative trading. Others, such as Bank for International Settlements (BIS) chief Agustín Carstens, want to protect the banks from the headwinds building in financial markets as the Fed winds back the Quantitative Easing (QE) program that has kept the banks in their gambling habit since the 2007-08 global financial crisis.

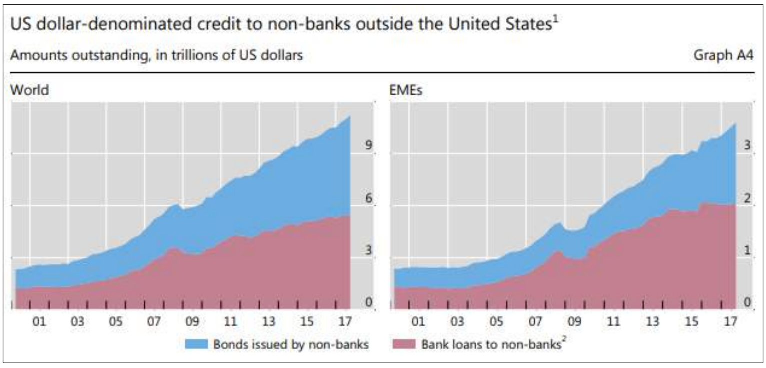
Many analysts and political figures, both in the USA and Europe, are warning that the tapering of QE must stop, or that *new* QE money-printing should be initiated to help banks weather upcoming financial shocks. Several members of the US Fed's Federal Open Market Committee and regional Fed presidents have opposed the one or two interest rate increases planned for the remainder of 2018. Credit Suisse chief financial analyst and former NY Fed official, Zoltan Pozsar, told CNBC that a "Balance sheet taper from here [on] will cut right into the system's liquidity bone."

Last weekend (25-26 August) central bankers from around the world gathered at Jackson Hole, Wyoming for their annual meeting. On behalf of the BIS, a.k.a. the central bank of central banks, Agustín Carstens warned that the reversal of globalisation, with the revival of tariff barriers, would not only have an economic impact, but a financial one. According to a 27 August *Sydney Morning Herald* summary by Stephen Bartholomeusz of Carstens' talk at Jackson Hole, the BIS big-wig warned that a collapse in global trade could cause financial markets to unravel. The interplay between "real" and "financial" downturns, he said, would exacerbate each other, leading to a "perfect storm".

Carstens pointed to complicated "global value chains" where trade in intermediate goods is nearly twice the size of finished goods, for example, in car manufacturing. This requires "complex financial services" and "complex derivatives and hedging strategies", he said, according to *SMH*'s summary. Hence Carstens' concern about the "financial inter-dependencies" between trade and, in our choice of words, the global financial bubble.

As US input prices rise as a result of pricier imports (from China for instance), inflation will increase, as will pressure on central bankers to raise interest rates, Carstens said. The US dollar would further strengthen, hurting US exporters (many already overextend with debt) while also inflaming the crisis in emerging markets.

Carstens reminded the forum that there is some $11.5 trillion of US dollar credit held by non-banks outside the USA, and that appreciation of the dollar tightens that credit. Add in the dollars held by banks, including in derivatives contracts ($13-14 trillion in $US lending, according to BIS figures), and it is clear that an implosion of this sea of debt brought on by higher US rates and tighter credit would have enormous implications.



BIS graphs showing the rapid growth of US dollar lending worldwide and in emerging markets, to non-banks, i.e. corporations, governments and other private entities. Source: BIS

While US President Donald Trump has criticised the Federal Reserve for raising rates, Fed Chairman Jerome Powell told the Jackson Hole gathering that the gradual normalisation of interest rates would continue. According to Nomi Prins, last October Powell had insisted that emerging market issues would be "manageable", but the implications of a reversing "carry trade"—the practice of borrowing at near zero interest rates in one location, to re-lend anywhere in the world that offers higher yields—can be dire. Remember the yen carry trade of 2004-08? Where yen could be borrowed at 0.0-0.5 per cent interest rates? Remember the countries that were blown up by that and similar trades, from Thailand (1997), to Turkey (2001) and Iceland (2006)? The unwinding of the yen carry trade, which had helped bloat the global speculative bubble, contributed to it blowing up ten years ago. Today, short term interest rates in Japan are *negative 0.1 per cent*! And US rates have been effectively zero for ten years.

In a 15 August article for *Daily Reckoning*, Prins warned about today's sea of debt swamping the world. Since the GFC, she said, global debt has ballooned, reaching record levels in emerging markets, mostly denominated in US dollars. That debt is now becoming too expensive to repay, she said, and when you are talking about the debt of nations—sovereign debt—the deadlines are hard. "If a country misses a debt payment, it could set off a chain reaction of defaults", she said. "That's why an EM [emerging market] crisis could quickly become a global crisis."

The US Fed needs be concerned therefore with the boomerang effect it is unleashing by its tightening program. Is the Fed, in conjunction with major Wall Street and City of London banks, wielding an economic weapon against emerging market economies, which show signs of banding together to create an alternative to the trans-Atlantic, dollar dominated financial order? Nations coalescing around the BRICS (Brazil, Russia, India, China, South Africa) alliance are increasingly trading in their national currencies, and have discussed taking this further, at forums such as the BRICS' South Africa summit on 27 July ("BRICS summit looks ahead 'as old order falls apart'", *AAS* 1 Aug. 2018). With a globally coordinated approach, such as a revival of the Bretton Woods fixed exchange rate system (see p. 7) they could successfully pull it off, but this requires getting the USA on board. Trump, if he truly wants to see America become great again, must be brought to consider this and to realise how his trade war and other policies are playing into a new global crisis scenario, because there is no doubt that the damage that will be wrought upon the world's developing nations will come back to hit the USA.